Service Date: July 3, 2003

DEPARTMENT OF PUBLIC SERVICE REGULATION
BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MONTANA

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IN THE MATTER of the Application of NorthWestern Energy's: (1) Unreflected Gas Cost Account Balance and Projected Gas Cost; and (2) Gas Transportation Adjustment Clause Balance.	)	UTILITY DIVISION DOCKET NO. D2002.11. 140 ORDER NO. 6468c

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FINAL ORDER

FINDINGS OF FACT

1. On November 13, 2002, NorthWestern Energy (NWE) filed with the Montana Public Service Commission (Commission) an application for approval of gas rates which:

A) Reflects rate treatment for the balance in Account No. 191 (as Adjusted), Unreflected Gas Costs, for the 12-month period ending October 31, 2002.
B) Reflects the projected tracking market, supply and gas costs for the 8-month period November 1, 2002 to June 30, 2003;
C) Reflects rate treatment for amortization of the GTAC Balance (as adjusted), for the 12-month period ending October 31, 2002;and,
D) Extinguishes the unit amortizations in the current rate schedules, approved in Order No. 6394d.

2. NWE stated that it is imperative to continue to provide price transparency and the lowest supply cost possible. The shift of tracker years to the July to June timeframe is designed to assist NWE in estimating the actual supply cost and effectively align the tracker year with the supply and storage procurement strategies. NWE stated that the proposed change in the rate filing period change would provide customers with more price transparency before the prime heating season.

3. NWE stated the projected gas price for the eight month tracker period is $3.3741 per dkt compared with $2.17 per dkt in 2002 and $3.832 per dkt in 2001. NWE stated it

purchases wholesale natural gas from producers and passes the cost directly on to customers without mark-up. The net adjustments proposed by NWE in this filing result in the following:

A) A change of 35 per cent to the commodity based rates for core residential customers;
B) A 29 per cent change for general service customers.
C) The utility class commodity based rates will change 103 per cent and the reservation rate will change -6 per cent.
D) The transportation reservation rate at the distribution level for firm service (Rate Schedule D-FTG-1) will change -0.34 per cent.
E) The transportation commodity based rates at transmission level for firm service (Rate Schedule T-FTG-1) and interruptible service (Rate Schedule T-ITG-1) change -26 percent and -8 per cent respectively.
F) The storage reservation rate (Rate Schedule T-FSG-1) will change by -16 per cent.
G) The core and utility rates reflect decreases, primarily because of an increase in this tracker's gas cost projections.
H) The transportation and storage rates at distribution and transmission level change because of the net rate impact of activities associated with the GTAC mechanism.

4. NWE requested interim approval of the proposed new gas rates to become effective for services rendered on and after December 15, 2002. NWE stated that absent an interim increase it will experience significant cash flow shortages, which will have a detrimental effect on it in advance of a rate adjustment, and will place a greater future burden on customers. NEW indicated customers are fully protected if an interim increase is granted. If in the final order, it is determined that rates should have been lower, a complete refund to customers of any over-collection will be paid back plus interest at a rate of 10.75 percent.

5. In his prefiled testimony of November 2002 Philip Maxwell, NWE's Senior Analyst, presented gas cost revenues and gas cost expenses and explained how they were derived. Mr. Maxwell also presented the proposed amortization of the Gas Transportation Adjustment Clause (GTAC) Balance for the 12-month period ending October 31, 2002 and the cessation of the current Unreflected Gas Cost Account and GTAC Balance amortizations.[1]

6. Mr. Maxwell stated that gas cost revenues are the portion of the booked natural gas revenues associated with gas costs. He said each month the recorded consumption provides the source data to which the appropriate unit gas cost revenue component of the rates are applied.

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[1] Philip Maxwell prefiled testimony page PEM-3

The adjusted Unreflected Gas Cost Account Balance proposed for amortization in this filing is $3,959,306.12.[2] The account balance is the sum of the 2001-2002 tracker un-reflected gas cost balance from Order No. 6394d, $2,667,381.99 and the 2001-2002 tracker deferred account balance, $1,291,924.13.

7. The purpose of the Gas Transportation Adjustment Clause (GTAC) mechanism is to track the difference between the estimated revenues of $2,795,984 reflected in rates and actual revenues received. The GTAC Balance for the 12-month period ending October 2002 is $1,135,097.90[3], which is the difference between total GTAC revenues of $4,184,407.07 and total offsets of $3,049,309.17. NWE is proposing to cancel the GTAC Balance unit amortization and include the balance of ($21,638.11) with the 12-month ended October 31, 2002 balance of ($1,135,097.90) for a total GTAC amortization in rates of ($1,156,736.01).[4]

8. NWE proposed that the GTAC tracking year be changed to July 1 to June 30 to coincide with the new tracker filing period discussed in the prefiled testimony of NWE witness John M. Smith.

9. John Smith, NWE's Manager of Energy Supply, discussed in his prefiled testimony of November 2002 the actual gas market, supply, and costs for the 12-month period ended October 31, 2002; NWE's proposal for changing the gas cost tracking year to the end of June of each year; the expected gas market, supply and cost for the 8-month period, November 1, 2002 through June 30, 2003; and the adjustment that must be made to the deferred gas amortization account to comply with the Stipulation Agreement in Docket No. D2001.12.156 (due to NWE's early termination of the buy-back contract).

10. Mr. Smith described the projected $0.56/Dkt increase in gas supply rates from the previous year's estimate:

> "The market price for natural gas increased during 2002. NWE's gas supply portfolio benefited from the below market "buy-back" contract through most of 2002 that covered approximately 40% of the total supply requirements at a fixed price of $1.60/Dkt. NWE currently purchases on-system third party gas at prices tied to the competitive market. The increase in gas cost is offset however, by an aggressive supply and storage portfolio management strategy. NWE purchased off-system gas this summer for storage refill, at very attractive prices…The prices NWE will pay for gas supply this winter for the remaining supply positions are set at current projections of the market price." Direct Testimony, JMS-6

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[2] Philip Maxwell prefiled testimony page PEM-4
[3] Exhibit_(PEM-2) page 5
[4] Philip Maxwell prefiled testimony exhibit PEM-2 page 5 of 5

11. The $3.1398 per dkt was the 8-month estimate of gas costs if the rate went into effect on November 1, 2002. Because the requested effective date was December 15, 2002 both the unit gas cost and the prior year Deferred Expense amortization unit needed to be modified. The gas cost component was increased from $3.1398 per dkt to $3.3741 per dkt and the deferred account amortization unit cost was changed from $(0.2976) per dkt to $(0.2121) per dkt.[5]

12. NorthWestern's Application cover letter at page 2 of 5, dated November 13, 2002, described the referenced five-year below market buy-back contract, supplying approximately 40% of the total supply requirements, as saving customers $55-70 million over the term of the contract as compared to short-term market prices. Further:

> "NorthWestern will continue to be forward looking and seek opportunities to benefit customers. The market is affected by numerous supply and demand factors (such as regional weather patterns). In addition to the fundamental influences, the market is affected by technical and psychological (anticipation of world events) factors. *NWE has developed a systematic risk management policy. This policy will maintain a portfolio of supply contracts executed at specific periods throughout the year. In addition to the disciplined risk management strategy, NWE will maintain flexibility to benefit from short-term market movements*." Italics ours.

13. NWE proposed the tracker filing date be changed from November 1 to July 1 to help reduce the chances of large over or under collection that can happen during the heating season. The lack of heating demand in the summer, according to Mr. Smith, will lessen the problem of having historical rates applied to large winter sales volumes.[6]

14. On December 12, 2002 the Commission approved the full increase proposed by NorthWestern on an interim basis effective December 15, 2002, subject to rebate with interest in the event final rates were approved at a lower level (69-3-304 ARM).

15. On January 7, 2003 the Commission received a request from the Montana Consumer Counsel (MCC) for intervention in Docket D2002.11.140 and intervention was granted.

16. During the week of January 27, 2003 staff from both the Commission and the MCC conducted a discovery audit in Butte, Montana on the books and records of NorthWestern Energy.

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[5] John Smith, prefiled testimony page JME-7

[6] John Smith prefiled testimony page JMS-5

17. On March 18, 2003 direct testimony by George L. Donkin, witness for MCC, was filed. The purpose of Mr. Donkin's testimony was to analyze the annual gas costs and gas cost filing of NWE. Mr. Donkin stated as a result of his previous participation in various cases filed by the Montana Power Company, NWE's predecessor, he has become very familiar with the gas supply market conditions on the NorthWestern system.[7]

18. In addition to the initial cover letter and prefiled testimony and exhibits provided by NWE in this filing Mr. Donkin reviewed responses to data requests by MCC and Commission staff; information provided by NWE to the MCC and Commission staff at an on-site discovery audit conducted in Butte in January of 2003; various forms of public information that are routinely used by gas supply analysts relating to gas supply market conditions both nationally and on the NWE system in Montana; and, gas supply contracts for gas purchased during the historical period and the expected purchases during the projected period. Mr. Donkin also reviewed proprietary responses to data requests that described NWE's overall gas supply planning strategy.[8] Mr. Donkin found NWE's cost of purchased gas in the projected period to be more than $1.00 per dkt higher than it was during the historical period.[9]

19. Mr. Donkin gave two reasons why NWE's purchased gas costs per dkt were higher for the projected period than in the historical period. He stated:

> (1) For eight months in the Historical Period, NorthWestern purchased large quantities of gas supply under the November 1, 1997 Supply Contract, that was developed and made an integral part of Stipulation Agreement No. 3 in Docket No. D96.2.22. That Supply Contract terminated, effective June 30, 2002, and the replacement supplies thereafter have been at much higher market prices.
> (2) Almost all other gas supplies purchased by NorthWestern are at much higher market prices in the Projected period, in comparison with the Historical Period. This is because most of the other gas that is and has been purchased by NorthWestern has been at contract prices based on market price indices, and the Company has not entered into hedging transactions to mitigate the effects of supply price volatility.[10]

20. Mr. Donkin's testimony addressed the issue of hedging strategies to mitigate gas supply price volatility:

> "Q. Does Northwestern engage in hedging strategies to mitigate gas supply volatility?

[7] George Donkin, direct testimony page 4
[8] George Donkin, direct testimony page 6
[9] George Donkin, direct testimony page 10
[10] George Donkin, direct testimony page 10

> A. Only to a very limited extent. The term “gas supply price volatility” refers to the fact that commodity prices of natural gas are often unstable, and they often increase or decrease unpredictably, and sometimes by significant amounts. In fact, natural gas supply prices may be the most volatile of all commodity prices.”
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> It is possible to “hedge” against gas supply price volatility. One way to do this is to enter into fixed price gas supply contracts. NorthWestern has some fixed supply contracts, but they represent a very small percentage of the Company’s total purchases, in both the Historical Period, and in the Projected Period. Measured in terms of volumes, almost all of the Company’s gas purchases have prices that are determined by specific market price indices. Accordingly, those contract prices will move up or down in response to changes in the applicable price indices.” p. 7, line 12- p. 8, line 5.

21. Mr. Donkin then described other hedging type transactions (e.g., calls, puts, collars) that could be employed to mitigate the volatility of indexed prices. p. 8, lines 6-18. Later Mr. Donkin provided his overall opinion concerning NorthWestern’s decision to rely almost exclusively on contracts containing market price indices, rather than hedging with fixed priced contracts or other alternatives:

> “Q. Should NorthWestern have engaged in hedging transactions to mitigate the effects of gas supply price volatility?
> A. I am not in a position to state at this time that NorthWestern should have engaged in hedging transactions in an effort to mitigate the effects of gas supply price volatility. This is so for two reasons:
> (1) I am not aware of the extent to which, if at all, the Company’s default supply portfolio customers place a value on price stability, as opposed to possibly paying somewhat lower, but more volatile gas supply prices, over time; and
> (2) I am not aware of the additional costs that would have been incurred if it had engaged in hedging transactions in the past in an effort to mitigate the effects of gas supply price volatility. p. 11, lines 1-13

22. In conclusion Mr. Donkin recommended that the Commission consider establishing a Gas Supply Working Committee. He suggested this committee would analyze in detail the potential benefits and costs of NWE entering into hedging transactions in an effort to mitigate the effects of gas supply volatility.[11] He indicated several areas for the committee to focus on including: identify the type and estimated costs of alternative hedging; measure or estimate to the extent which members of the default supply customer community place a value on gas supply price stability; and identify the extent to which hedging transaction are used by

[11] George Donkin, direct testimony page 11

LDC's in other regulatory jurisdictions.[12] Mr. Donkin recommended that the Gas Supply Working Committee consist of, at a minimum, NWE, Commission and MCC staff, and the results of its findings be reported to the Commission.

23. On April 1, 2003 Commission staff submitted data requests to Mr. Donkin regarding his direct pre-filed testimony. On April 15, 2003, the Commission received the responses from MCC's witness Mr. Donkin.

24. In data request PSC-1 Mr. Donkin was asked if he were aware of any proceeding to evaluate the prudence of MPC/NWE's gas supply strategy and contracting practices. Mr. Donkin stated he was not aware of any proceeding established by the Commission since 1990 for that purpose.[13] He further stated that his recommendation in Docket No. D2001.12.156 that recoverable gas cost be reduced was based on MPC's early termination of the November 1, 1997 Gas Supply Contract. His recommendation was not based on an evaluation of MPC's overall gas supply strategy and contracting practices.

25. In PSC-3 Mr. Donkin was asked if he considered it a prudent gas supply and acquisition strategy to have virtually all gas supply contracts under market price indices and virtually no fixed price contracts of various durations. In response Mr. Donkin said yes, but a combination of contracts having various durations, may also be prudent. He cautioned that the longer the term of fixed price contracts, the greater the risk of contract price becoming significantly out of line with prevailing market prices.[14] Mr. Donkin said he would generally not support as prudent an LDC gas supply portfolio that contains more than 20% of total supplies having fixed prices and terms of six months or greater, unless the fixed contract prices also have hedging transactions to protect against future price volatility.[15]

26. In response to PSC-3(e) Mr. Donkin provided a summary of the most important overall objectives and elements he considered in developing a gas supply portfolio: "supply reliability, supply flexibility, and *reasonable costs*". He described a number of advantages offered by NWE's gas supply, including multiple supply sources from three different supply areas in combination with its gas storage facilities, which "makes it relatively easy for NorthWestern to operate a reliable gas supply delivery system and obtain reliable supplies at

[12] George Donkin, direct testimony page 12
[13] George Donkin response to data request PSC-1
[14] George Donkin response to data request PSC-3
[15] George Donkin response to data request PSC-3

lowest reasonable costs" … "But to be successful in this effort, NorthWestern should ensure that the provisions in its gas supply contracts provide for *market responsive prices*. This is necessary to ensure that NorthWestern's overall commodity cost of gas *is never significantly greater than prevailing market prices*." (Italics ours.)

27. In response to PSC-4, Mr. Donkin described the way in which the Company replaced the fixed annual price "buy-back" contract that was established 11/1/97 and terminated on June 30, 2002: "I did determine, however, that …it was replaced by a new contract with the same supplier, but the contract prices were based on market price indices. That is so for both the Historical Period and the Projected Period in this docket." Mr. Donkin was, of course, intimately familiar with the beneficial buy-back contract, which he substantially negotiated on behalf of MCC and which resulted in a stipulated settlement in Docket No. D96.2.22 ultimately approved by the Commission in Order No. 5898(d) dated October 31, 1997. The stipulated fixed annual prices per Dkt for the five year contract commencing November 1, 1997, were: $1.75; $1.60; $1.50; $1.50; and $1.60.

Public Hearing & Cross-Examination

28. On May 21, 2003 a public hearing was held in Docket D2002.11.140 at the offices of the Commission in Helena, Montana.

29. During cross examination of Mr. John Smith he was asked whether he was aware of the contract by the State of Montana that went to the market for RFP's for a firm price contract. Mr. Smith said he was and he understood that the price in the state contract was in the $3.50 per dkt range. When questioned if the firm part of that contract was at $3.10 per dkt, Mr. Smith agreed it was, subject to check.[16]

30. During recross-examination Mr. Smith stated that NWE had not obtained any fixed price contracts.[17] When asked if NWE had considered entering contracts based on futures or using futures to guide the negotiation of firm contracts, Mr. Smith responded: "We have considered fixed pricing, but it's our understanding that the MCC, at least, wanted us to market, and we have been pursuing market prices."[18] MCC asked Mr. Smith if he could explain the basis of his statement that the MCC wanted or asked NWE to pursue market pricing. Mr. Smith said:

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[16] Transcript of proceeding, page 19, line 6
[17] Transcript of proceeding, page 41, line 13
[18] Transcript of proceeding, page 42, lines 11-14

> "Well, that was based on our conversations during the tracker audit that we had, and Mark went into some detail on the board and explained how we might purchase certain portions of our supply on a fixed-price basis, and then we got into a discussion with Mr. Donkin about that. At least what I took away from that discussion was that if we were trying to outguess the market, and if we guessed right, we would get a pat on the back, but if we guessed wrong, it could be non-beneficial to the Company and that we should probably just buy our gas at market."[19]

When asked if he was aware of any formal communication along those lines, Mr. Smith said he was not.[20]

31. On cross-examination MCC witness George Donkin was asked to respond to Mr. Smith's comments about pursuing market pricing. Mr. Donkin responded:

> "Sure. I'll address first this issue that relates to the discovery session in Butte. I certainly did not intend to convey at that meeting that NorthWestern should pursue an all-index strategy because it is risk free to them in terms of cost pass-through. I think what I said, and I'm going from memory, and I should even preface that by with respect to the whole issue of fixed versus index and layering in of certain supplies at different contract dates and terms at fixed prices, I mostly listened while I was there. Remember this was a discovery session, but I do recall at some point volunteering that I was aware of other LDCs who had chosen to go all index because it was generally believed that that was a safe route in terms of their regulators. How could you be faulted if you're purchasing at market prices. But I didn't mean to convey that that was my recommendation that NorthWestern Energy pursue. Moreover, in terms of the issue in this tracker, at the date of that meeting it's sort of an irrelevant point anyway because the decisions had been made well in advance.

32. The "NorthWestern Energy, Natural Gas Supply, Position and Strategy Following July 1, 2002, dated June 28, 2002" (NWE's Supply Strategy or Strategy) , was provided in response to MCC Data Request 5 (b). On cross-examination Mr. Smith stated that the referenced Strategy report was developed during the spring of 2002. "I would say it developed during spring and early summer of 2002. Probably started in mid-March and ran until mid-June, the final document." Transcript p. 16. Mr. Smith stated at hearing that he believed the report was presented to NWE management on June 28, 2002. Tr. p. 16. The buy-back contract was scheduled to terminate on June 30, 2002. A number of the findings below involve NWE's Strategy.

33. NWE's supply strategy described the important role of its gas storage:

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[19] Transcript of proceeding, page 43, lines 6-16
[20] Transcript of proceeding, page 43, lines 17-19

"A key strategy for hedging to cover peak day and limit commodity volatility will be an aggressive injection schedule to optimize storage."

34. NWE's supply strategy discussed its existing portfolio and graphically illustrated its "open positions":

"NWE has entered into strategic supply agreements with EnCana, Ocean and Tenaska, which will cover over 100% of our normalized requirements and 65% of our winter peak requirements. These transactions are index-based *with the ability to convert to fixed price. NWE has focused on fixed price storage injections to protect against portfolio price volatility. NWE expects to purchase more fixed price supply before November*. This chart illustrates the need for a defined energy procurement policy that provides NWE the ability to embrace market fundamentals and the flexibility of the system, *while also securing a portfolio of energy supply products to limit the impact of the wholesale natural gas volatility*." Italics ours.

35. NWE described three load scenarios to test future sensitivities for load variations due to weather and customer choice:

"Using the flexibility offered by the Default Supplier's contracted storage rights, the discretionary winter gas, and the summer storage refill estimates *there are no realistic scenarios which would place undo risk on costs and operations of the proposed supply portfolio*." Italics ours.

36. NWE's Strategy described gas pricing issues, specifically *fixed versus index*:

"NWE has historically kept more than 50% of its annual requirements under fixed price contracts. The former affiliated contract that is now supplied from EnCana Energy has comprised the largest piece of fixed price gas. During the last twelve months of this contract (expiring June 30, 2002), NWE will take 8,400 MDkt at a fixed price of $1.60/Dkt. The 8,400 MDkt comprises 42% of NWE's annual supply requirement. The expiration of this contract requires NWE to be more aggressive in transportation and storage opportunities. The strategy for the remainder of 2002 will be to maintain a steady injection due to the low spot market in correlation to the forward curve. Secondly, NWE will access opportunity purchase on CIG through contract or spot purchases that reflect lower costs than alternatives."

"In conclusion, NWE is developing a comprehensive risk management plan that monitors price and volatility of supply. Specific predetermined hedge targets, price and volatility limits and market fundamentals will guide hedging decisions. The new risk management policy will be implemented in April of 2003, since the winter hedging strategy is already in place to mitigate substantial price volatility in the upcoming heating season. The Risk Management and Procurement Policy will need to be reviewed with the PSC and MCC prior to embarking on any subsequent strategies."

37. NWE then described its **"Guiding Principles for Risk Management and Procurement Policy"**:

> "First it should be understood that there is no 'Industry Standard' approach to establishing guidelines related to energy acquisition and fixed vs. indexed pricing schemes. Each utility or end user customizes these policies and procedures to meet their individual needs: MDU uses 100% index pricing, certain eastern utilities hedge 90%+ of annual supply needs, *and most other utilities or aggregators fall somewhere in the middle*.
>
> *Because the Default supply customers of NWE are those customers which the competitive market will not choose to supply and those customers are the least able to bear the risk of high or volatile pricing*, NWE must structure a pricing and procurement policy that addresses the following inter-related and somewhat contradictory issues: **Default Supply rate with low volatility*; * Default supply rate that does not inhibit effective customer choice…*Default Supply package that mitigates risk to the Default Supplier and its remaining customers should there be large swings in load. *Bottom line, the Default Supplier must be able to provide a stable rate, with subtle changes reflecting market conditions.* Full protection from all price changes is not in the best interest of customers, a competitive market, not the Default Supplier.*"* *Italics ours.*

38. NWE concludes with its description of MPSC Regulation:

> "NWE flows all of its gas costs and related expenses through what is known as a the Gas Tracker filing with the MPSC…Based on prudent gas purchasing activities, the costs are trued up in the following year, such that the customers only pay for actual gas costs incurred and NWE recovers all of its costs….Historically, NWE has received full cost recovery for all gas supply activities associated with default supply."

39. Mr. Smith testified at hearing about the status of NWE's subsequent actions on the comprehensive risk management strategy scheduled for April 2003:

> "We were working on developing then and actually had a matrix that was evolving to determine when certain percentages of gas should be locked in for the upcoming winter periods. When Mr. Thompson arrived, that was kind of put on hold because he wanted to work on the risk management portion of the strategy, and it's yet to be developed or it's been kind of an ongoing process, and through the tracker, I think we're waiting to look for direction from both the MCC and the PSC." Tr. p. 20.

40. Mr. Smith testified on cross-examination that NWE had under collected in the deferred account:

> "We had a gas cost predicted for this winter of—on my supply contracts, my index supply contracts, I had an estimate in there for the winter of about, I believe, $3.50. We actually had to pay significantly higher than that, and I believe there will be a filing soon for the next tracker that will lay that out." Tr. P. 26. Mr. Smith then estimated the under-collection at "Approximately $13 million…as of the end of June, and that's with estimates for May and June." (Transcript p. 27)

41. Throughout the pre-filed testimony, exhibits, data responses and transcript of the public hearing are references to and discussions of published market price indices related to contract provisions, spot prices, month ahead/near month forward prices and longer term forward (future) price indices at AECO and CIG. The AECO and CIG index prices represent important basic market pricing data that must necessarily be included in the record evidence as a foundation for evaluating information which was known throughout the period of NWE's gas supply strategy and procurement. NWE gas supply acquisitions and contracts prices at issue are based on such market indices. The Commission takes administrative notice of the AECO and CIG indices for the period January 2000 to date.

42. NWE agreed in the course of Mr. Smith's cross-examination to provide a copy of the State of Montana's gas supply contract. *The State of Montana term contract, T.C.# SPB03-31G, dated 10/23/01, covers the two year period July 1, 2002 – June 30, 2004*. The State contract for Firm natural Gas Supply included up to 10,703 Dkt per day peak and approximately 2,640 MDkt over the 24 month period (or about 1,320 MDkt annually). *The fixed contract prices were $3.10/Dkt for the estimated 1,950 MDkt for facilities with firm storage and $3.30/Dkt for about 688 MDkt for facilities without firm storage. The weighted average fixed contract price approximates $3.15/Dkt under the State contract*.

Commission Discussion, Analysis, and Findings

43. The regulatory agency must apply the full breadth of its regulatory experience and expertise to the issues presented in cases. The Commission has a fundamental responsibility to apply its expertise to the record evidence in critically evaluating prudence (69-3-303 ARM).

44. The fundamental issue presented in this proceeding is whether NorthWestern has satisfied its burden of proof and whether NWE's gas supply strategy and procurements were prudent based on information and circumstances that were known or should have been known at the time by NWE's management. NorthWestern is responsible to provide firm, reliable gas supply service to its default supply customers at the lowest reasonable cost.

45. The point of departure in the Commission's evaluation of the prudence of NWE's gas acquisitions is the historic level or mix of over 50% fixed price contracts in its supply portfolio; the knowledge that its key fixed price buy-back contract for 8,400 MDkt or 42% of its annual supply was set to expire on June 30, 2002; the fact that gas prices are the most volatile of

all commodity prices (Donkin); the extreme volatility and price levels experienced in the natural gas (and electricity) market prices during the winter of 2000-01; and the long established regulatory goal of the lowest reasonable and relatively stable customer prices.

46. NWE was aware for several years that it faced expiration of its five year "buy-back" contract for about 8,400 MDkt or about 42% of its annual gas supply on June 30, 2002. The buy-back contract represented the largest portion of the fixed price supply contracts, which historically accounted for over 50% of its annual supply. NWE's testimony demonstrates that its Gas Supply Strategy for the period beyond June 2002 was not formulated until the Spring of 2002, beginning in mid-March 2002. The Gas Supply Strategy was presented to management on June 28, 2002. The Commission considers the late consideration of replacing the significant "buy-back" supply contract and establishing a post July, 1 2002 gas supply strategy to be extremely dangerous and borderline imprudent on its face.

47. Montana, the region and the nation had experienced extreme gas price volatility and skyrocketing prices during the winter of 2000-2001. MCC's Mr. Donkin (Finding 20) described natural gas prices as the most volatile of all commodity market prices. Entities and customers who directly experienced and paid the costs associated with market indexed prices during that period would be loathe to expose their businesses to such volatile market prices and extreme price levels going forward. Prudent, responsible gas supply planning and procurement practice would not risk exposure to short-term market price indices for an entire portfolio.

48. Similarly, the Commission, NWE, and Montana customers directly observed and experienced the electricity crisis of 2000-2001 on electricity prices. The extreme prices during the summer of 2000 (the California meltdown) and again in the winter of 2000-01 had a devastating impact on industrial customers in Montana who had either relied on short-term market index prices (tied to the mid-Columbia index) or were forced into indexed prices upon expiration of fixed price electricity contracts. Significant industry shut-downs, cut-backs, and employee lay-offs dominated both the headlines and the legislative session in 2001. Electricity prices had spiked from about \$25-\$30/Mwh to the \$300-\$600/Mwh for extended periods during the crises, which did not abate until the summer/fall of 2001. In the aftermath of the extreme exposure to the volatile and extreme levels of the short-term market indexed prices, it is well documented that industrial customers and other public entities entered into firm, fixed price

contracts for 2-5 years thereafter to mitigate the extreme risk of such upside price and volatility risk.

49. As illustrated by the State of Montana's gas supply contract (Finding 42), state facilities (including units of the university system), a significant number of school districts and several municipal facilities sought and obtained a fixed price, forward contract via an RFP process. The contract, dated October 23, 2001, was for deliveries commencing July 1, 2002 -- *the same date that NWE's buy-back contract for 42% of its annual gas supply expired*. The State's strategy illustrated the high value placed on known gas supply costs to serve budget constrained public entities. The contract strategy of the governmental entities/ subdivisions included in the State's aggregated supply contract mirrors the importance attached to competitive procurements for fixed price contracts by industrial customers as described by Mr. Donkin. Tr p. 59; Finding 56 A number of these entities had experienced the severe natural gas price spikes with indexed pricing and expired contracts during the winter of 2000-01.

50. The record in this case suggests that the attractive 5 year buy-back contract had insulated both NWE and its default supply customers from the extreme volatility and peak price levels during the 2000-01crisis. The extent to which NWE had avoided the extreme gas price volatility and levels during 2000-01 may have contributed to its failure to replace the fixed price buy-back contract with other fixed price contracts to mitigate risks associated with extreme gas price volatility and levels. NWE did not enter fixed price contracts or exercise the option of converting indexed contracts to fixed prices as contemplated in its strategy. Furthermore, the record in this case suggests that the transition to NWE ownership and management direction may have contributed to NWE failure to pursue the Strategy and risk mitigation program developed in the spring of 2002. The testimony of Mr. Smith described the delays adopting and implementing the Risk Management and Mitigation Policy (Finding 39). Finally, it appears that NWE remains paralyzed by anxiety or misunderstandings about the guidance of MCC witness Mr. Donkin and about Commission policy and expectations on gas supply and procurement strategy. While the working committee and gas forum concepts may well offer some added guidance it is NWE that has the management responsibility to prudently and responsibly acquire and implement gas system management, including storage, in a manner that produces the lowest reasonable delivered gas supply cost.

51. Despite the late timing of its study, NWE's own strategy correctly described the prime importance of rate stability for default supply customers (Finding 37). "*Because the Default supply customers of NWE are those customers which the competitive market will not choose to supply and those customers are the least able to bear the risk of high or volatile pricing*, NWE must structure a pricing and procurement policy that addresses the following inter-related and somewhat contradictory issues: **Default Supply rate with low volatility…Bottom line, the Default Supplier must be able to provide a stable rate, with subtle changes reflecting market conditions."*

52. NWE's strategy contained a number of key elements necessary to mitigate gas supply price volatility, but NWE failed to prudently execute the fundamental procurement practices designed to acquire reliable gas supplies at the lowest reasonable and stable cost. The record demonstrates that NWE abandoned its historic, balanced reliance on about 50% of its annual gas supply at fixed prices and employed an acquisition strategy based entirely on market indexed prices. Findings 32-39

53. Despite having substantial flexibility due to multiple supply sources (Canadian, traditional north-central MT production areas, CIG supplies and access in south end/Wyo) and significant gas storage, NWE's failure to mitigate the gas price volatility in its base supply contracts substantially contributed to the extreme gas price increases during the eight month tracking period at issue in this docket (and the recently filed true-up tracker for the same period, Docket No. D2003.6.66). The record evidence suggests that the opportune prices from the south-end during the storage refill period gave NWE a false sense of security as it approached the winter season (Finding 36), when the risk of gas price volatility is most extreme. NWE acted responsibly in accessing storage refill at attractive prices. However, NWE failed to exercise the same level of risk mitigation on its base supply contracts, especially in replacing the "fixed price buy-back contract" for 8,400 MDkt or 42% of its annual supply. Rather, it exposed all of its non-storage supplies to market indexed prices. Findings 33-39.

54. NWE sought to justify its reliance upon virtually 100% indexed contracts by recounting its interpretation of MCC's witness Mr. Donkin's concerns about hedging and support for being at market with indexed price contracts. The commission emphatically rejects the shifting of responsibility for supply strategy from management to others. The responsibility for and prudence of NWE's gas supply and procurement policy and implementation rests

squarely with management. As Mr. Donkin noted in response to PSC-1 (b): "I did not participate in negotiations or a collaborative, or any before the fact inquiry into the gas supply and contracting strategy that MPC would employ to replace the November 1, 1997 buy-back contract, which MPC terminated effective June 30,2002." During cross-examination Mr. Donkin addressed NWE's interpretation directly (Transcript pp.66-67), concluding: "Moreover, in terms of this tracker, at the date of that meeting (end of January 2002) it's sort of irrelevant anyway because the decisions had been made well in advance." Mr. Donkin emphasized the management responsibility for gas supply and procurement throughout extensive cross-examination.

55. The Commission finds much in Mr. Donkin's recommended portfolio strategy useful (Finding 27). The missing element in defining lowest reasonable cost relates to the value of relative price stability in this most volatile of all commodity markets. Mr. Donkin's reluctance to conclude NWE was imprudent in relying exclusively on market indexed pricing was based in part on (1) his uncertainty concerning the extent to which default supply customers value relatively stable rates and (2) the cost of mitigating gas price volatility via hedging. (Findings 19-21)

56. Mr. Donkin did acknowledge the importance of price stability to certain customers or customer classes at hearing:

> "…You could certainly assure yourself as to what price you would pay by buying a forward contract for quantities that you would likely need during that period of time, and then you could probably offset that with a hedge. *So, if price certainty is something that is really important to you as a buyer, that would be a reasonable strategy*." Tr. p. 32
>
> "I think a lot of residential gas customers may feel that price certainty is more important to them." Tr. p. 58
>
> "I know many industrial firms—have a strong preference for knowing with almost total certainty what their gas prices are going to be…if they can firm up their production costs and if natural gas is a significant component of their total production costs, they seem to lean heavily towards entering into either fixed price contracts at a 12-month strip or other forms of hedging transactions to lock in a fixed price." Tr. p.59.

57. Mr. Donkin testified on cross-examination about the advisability of entering fixed price contracts after the extreme prices of 2000-2001 had moderated by the fall of 2001:

> "…Let's say for the sake of argument that in that summer period, even going into September or October of 2002 … I'm sorry, 2001. I meant 2001. I'm thinking in

terms of the facts in 2001, that a gas buyer chose to lock in price, say by buying at a two-year strip. I hesitate to say this because I don't have the numbers in front of me, but I'm pretty confident that if you went back and looked at the 24-month strip price that you could have entered into at that time, it would have been significantly lower than the prices that had been prevailing in the market over the last 6-month period. What does that mean? That means that everyone in the marketplace was not predicting where we are today. Not everyone. There may have been someone out there, okay. You probably couldn't have gotten $2.50, either, but there would likely have been some modest increase from $3 to maybe $3.20, $3.40, $3.50. I would have to look at the numbers. But whatever they are, they would have been lower than what actually occurred, and therein lies the dilemma, I think, for those who have to evaluate the reasonableness of the decisions that were made at the time they were made.

It's absolutely clear today as we sit here that had the Company entered into fixed-price contracts, let's say at a full strip price, if the price increases that have taken place recently and are expected to take place in the coming months would have been mitigated, gas costs would be lower. Was it an unreasonable decision not to enter into fixed-price contracts at that time? That's a tough one. I've not come to that conclusion. Otherwise, I would have told you in my testimony."[21]

58. Mr. Donkin recounted the downside price risk associated with locking fixed prices in the event market prices fall. Buyers, having observed the extreme prices of $9 and $10 during the 2000-2001 winter, locked in seemingly attractive fixed prices of $3.00 or less during mid-2001 for the upcoming heating season. Such buyers "ended up paying a whole lot more than had they purchased at index in that period of time" due to lower prices associated with the warmer than normal winter of 2001-02. Tr. p. 54

59. Mr. Donkin did acknowledge the relative upside price risk or exposure of extreme price volatility and levels compared to downside price risk:

"That's a really good point. Really what you're saying is if you're at $2.50 or $3.00, and it turns out prices are even weaker than that, they're only going to go down to maybe $1.75. If it turns out that the market really spikes, however, it can spike to a lot more than $5.00. As we've seen, it can go to $10.00, it can go to $18.00.

So as the market has evolved, back in 1995, for example, when I submitted prepared testimony in that MDU case, I don't think I was considering the possibility of $15.00 and $20.00 gas, or even $10.00 gas. Now we've seen that happen a couple times in recent years, and I think your point is really well taken and it would be a major factor to take into account in terms of not really trying to beat the market per se. You don't go into it trying to beat the market, but you might say to yourself, I'm willing to pay a premium, some increment over the

[21] Transcript of proceeding, pages 66-69

> average index during non-spiked periods, to ensure myself against that really severe situation where for a month or two the price goes up 400, 500 percent. That's a type of consideration that could be explored in some detail at this workshop forum, if it comes to pass, that I discuss in my testimony." Tr. p. 55-56

60. NWE captured importance and value of gas price stability in its Strategy (Findings 37; 51), but failed to execute the mitigation necessary to avoid extreme exposure to gas price volatility. Contrary to its strategy, it entered short-term market price indexed contracts. Market responsive prices and prevailing market prices do not mean exclusively short-term daily or near month market indexed prices. Longer term bilateral and forward contract price indices at AECO or strips of 12-24 months are readily available to guide firm contract price terms. Staggered contract terms for fixed price contracts for intermediate price periods 1-2 years (or even 5 years, Donkin, Tr. p. 57) provide ongoing opportunities for price determinations, thereby avoiding the price risk associated with the long-term fixed price contracts (e.g., the historic 20 year fixed price contracts Mr. Donkin described).

61. The record includes in this case includes extensive discussion of the gas prices experienced in the period leading up to the expiration of the buy-back contract. Mr. Smith and Mr. Donkin (Tr. pp. 67-69) acknowledge that fixed price forward contracts were available for terms of 24 months at prices in the \$3.00-\$3.50/Dkt range. (Trans p. 68) In fact, the State of Montana contract entered on October 23, 2001 provided for deliveries commencing July 1, 2002 for a period of 24 months at a weighted average price of about \$3.15/Dkt. (Finding 42) Forward prices of 12-24 months during the period from summer 2001 through fall of 2002 were generally in a range of \$2.50-\$3.50/Dkt. NWE in fact included its estimate of \$3.50/Dkt in the instant tracker case for the 8 month period November 2002-June 2003.

62. Mr. Donkin testified at hearing concerning NWE's efforts to enter fixed price supply contracts: "With the benefit of hindsight looking back on the pricing issue, while lip service was paid in the document (NWE strategy) to possibly entering into some fixed price contracts, there really weren't any." Tr. pp. 63-64 In response to Commissioner Jergeson's examination:

> "Q…John Smith indicated that NorthWestern Energy was willing to consider or negotiate fixed, long-term contracts, but that all of the suppliers or producers insisted on index contracts. Did you understand his answers that way?
> A. Pretty much so. It wasn't clear that they insisted on it. What I got from it was that that's all they were interested in bidding on. That raises the question, well,

> what if the RFP said we have to have some fixed pricing, as well, and if that were to occur, what would be the response? Presumably, under certain circumstances some sellers are willing to enter into fixed price contracts, as well.
>
> I think that if an LDC made it very clear that it was interested in—it really wanted to enter into a fixed price contract for a portion of its load, it could get there." Tr. p. 81

63. The Commission does not expect or demand perfection in evaluating the prudence of NWE's gas supply and procurement strategy. The Commission does not expect perfection in picking absolute price "bottoms" in acquiring lowest reasonable gas priced contracts to mitigate gas price volatility. Nevertheless, NWE and Mr. Donkin have effectively assigned a value of zero to rate stability and mitigation of gas price volatility by pursuing or accepting supply contracts based exclusively on market price indices. This is true both during the period at issue in this case and in the pending tracker (Docket No. 2003.6.66), involving actual gas costs experienced during the same period as well as the 12 month forecast period commencing July 1, 2003.

64. Mr. Donkin provided his expert opinion in his direct testimony, responses to data requests, and live cross-examination *that he could not conclude that the actions of NWE in relying exclusively on market indexed contracts were imprudent*. The Commission respects but does not agree with Mr. Donkin's opinion. The Commission will answer both of the questions or concerns stated at p.11 of Mr. Donkin's direct testimony, which explain his reluctance to challenge the prudence of NWE in failing to mitigate the effects of gas price volatility through fixed prices or other hedging transaction for a portion of its supply:

- Gas price stability for default supply customers is a key objective -- as it is for electricity. NWE's strategy also focuses on stable default supply rates. (Finding 37) The Commission's default supply rules for electricity focus squarely on the importance of rate stability as a primary goal and objective: " In order to satisfy its default supply responsibility a DSU should pursue the following objectives in assembling and managing an electricity supply portfolio. The DSU should: (1)(a) provide default supply customers adequate and reliable supply services, stably and reasonably priced, at lowest long term total cost." See especially Rules: II-IV (38.5.8202-04).

- MPC/NWE have traditionally relied upon fixed price contracts (or company owned cost of service gas production) for over 50% of its gas supply, which has substantially mitigated gas cost and pricing volatility. While there has not been a study of additional costs, if any, associated with fixed price contracts or other hedging alternatives, there is a solid recognition of the importance relatively stable prices in lowest reasonable cost paradigm.

65. Based upon the whole record in this case, the most direct and reasonable approach to ensuring that default supply ratepayers are not exposed to the excessive prices resulting from NWE failure to replace the fixed price "buy-back" contract with a comparable fixed price contract mix is to reprice 8,400 MDkt at the level of $3.50/Dkt. An allowable gas price of $3.50/Dkt is at the high end of available fixed price supply contracts that could reasonably have been obtained via RFP or contract negotiations, consistent with NWE's own Strategy based on forward prices for periods of at least two years. The $3.50/Dkt level of allowed prices, applied to the 8,400 MDkt or 40% of the annual gas supply, are significantly above the price level of about $3.15/Dkt for the State contract for a 24 month period commencing July 1, 2002. The window of opportunity for NWE to enter such fixed price contracts at or below the $3.50/Dkt price existed for an extended period from the summer of 2001 through the fall of 2002. The Commission finds it reasonable that NWE would have entered (1) a two year contract(s) for 4,200MDkt or 50% of the buy-back contract level and (2) a one year contract(s) for the remaining 4,200MDkt each commencing July 1, 2002 at the allowable $3.50 per dkt price.

66. The Commission does not intend that a specific 40% fixed price contract mix (or NWE's historic 50%+ fixed price mix), based on the record in this case, is the "be all or end all" for gas supply strategy and procurement going forward. Rather, the Commission accepts Mr. Donkin's recommendation concerning a Working Committee to help shape a reasoned approach to future strategies for NWE. In addition, the Commission had previously scheduled a natural gas summit for mid-September that will include other Montana gas utilities and stakeholders as

well as national participants. The commission also agrees with Mr. Donkin that such a process does not relieve NWE of the ongoing need to act rather than shift its responsibility to other entities. Use of the NWE working group or advisory committee to mitigate risk for its shareholders and customers is consistent with the Commission's electricity default supply rules.

67. The level of the rates sought in this tracker case are based on the $3.50 NWE projection, and the Commission has determined that $3.50/Dkt was a reasonable but high-end price for firm fixed price contracts that were available to NWE during the period leading up to the June 30, 2002 buy-back contract expiration, even into the fall of 2002. Consequently, the Commission approves the interim tariff levels as final rates in this docket.

68. It is in the most recent gas tracking case, Docket No. D2003.6.66, filed on June 3, 2003, that the Commission's imprudence determination with respect to NWE's gas supply strategy and procurements will have its effect. The determination will modify both gas rates related to claimed deferred or under-collected gas costs for the period November 1, 2002-June 30, 2003 (the same period used for projected gas costs in this tracker case), and the projected gas cost component for the next twelve months. The interim decision in Docket D2003.6.66 will issue prior to July 1, 2003, and will be based on the Commission's determination in this case.

69. The Commission recognizes and equity counsels that in establishing an allowable gas price of $3.50/dkt for a portion of NWE's annual gas supply related to (1) the under-collected gas account and (2) projected twelve month period, that $3.50/Dkt is fixed for that period. In the event actual gas costs to NWE under the associated indexed contract(s) is less than $3.50/Dkt during the projected period, NWE is entitled to retain the savings just as if the fixed price contract had been entered (i.e. customers would bear the downside price risk just as they would have under a prudent fixed price contract).

70. The Commission is persuaded that issues related to proper incentives for NWE as a default supplier deserve a comprehensive evaluation. Mr. Donkin's testimony at hearing, concerning the need for focused incentives for the default gas supply function, is consistent with the testimony of Dr. Power and Ralph Cavanagh in the electricity default supply rulemaking hearing in January 2003. By this Order the Commission intends that the Working Committee proposed by Mr. Donkin (Finding 22) include the default supplier incentive issue in its action agenda.

71. NWE is directed to file with the Commission by July 30, 2003, a detailed proposal for a natural gas working group or advisory committee, either a stand alone committee or affiliated with the existing electricity Advisory Committee. As an initial matter the advisory committee would focus on natural gas procurement, but could also be expanded to consider rate design, customer impact or other issues. The Commission may request comments on the NWE proposal before acting on it. Findings 22, 66, and 70.

CONCLUSIONS OF LAW

1. NWE offers regulated natural gas service in the state of Montana and is a public utility under § 69-3-102, MCA.
2. The Commission properly exercised jurisdiction over NWE's Montana operations pursuant to Title 69, Chapter 3, MCA.
3. The existing rates approved on an interim basis, effective December 15, 2002, are approved as final rates in this Docket.

ORDER

1. The existing rates approved on an interim basis, effective December 15, 2002, are approved as final rates in this Docket.
2. The rates in this Final Order will be effective for all services rendered on and after December 15, 2002, the effective date of the interim rates.

DONE AND DATED in open session at Helena, Montana, this 19th day of June, 2003, by a vote of 3 to 2.

BY ORDER OF THE MONTANA PUBLIC SERVICE COMMISSION

____
BOB ROWE, Chairman

____
THOMAS J. SCHNEIDER, Vice Chairman

____
GREG JERGESON, Commissioner
(Voting to Dissent)

____
MATT BRAINARD, Commissioner

____
JAY STOVALL, Commissioner
(Voting to Dissent)

ATTEST:

Barbara Effing
Commission Secretary

(SEAL)

NOTE: Any interested party may request the Commission reconsider this decision. A motion to reconsider must be filed within ten (10) days. <u>See</u> *ARM 38.2.4806*.

Dissenting Opinion of Commissioner Greg Jergeson

OVERVIEW

Throughout the decade of the 90's, the champions of utility deregulation argued that utility deregulation would unleash the "genius of the markets." Assisted by industry funded think-tank theorists, they convinced compliant members of Congress and State Legislatures to ignore the natural monopoly characteristics of essential utility services and embark upon this disastrous experiment in deregulation.

While genius may have been unleashed, the rising dismay, frustration and outrage among consumers to rapidly escalating natural gas costs indicates that the adjectives they might use to describe that genius would not be positive. To be sure, natural gas increases on the magnitude of recent requests by NorthWestern Energy (NWE), with no end in sight to those kinds of increase, place enormous burdens on family and business budgets. Most NorthWestern customers are captive ratepayers with few, if any, alternatives to the use of natural gas as an energy source. The alternatives may be non-existent or even more expensive. The price induced conservation that the higher rates are expected to cause will, at a minimum result in inconvenience and discomfort, and in some cases will prove to be life-threatening.

Natural gas cost increases of these magnitudes represent a huge transfer of wealth from natural gas consumers. While the current public expressions of outrage are directed at NWE, that company is not the recipient of that wealth transfer. They are little more than the pass-through agent. The recipients and beneficiaries of this transfer of wealth from natural gas consumers are the suppliers, primarily natural gas producers, from whom NWE must secure its supplies of natural gas to deliver to the consumers. My public record clearly demonstrates that I have never been an apologist for Montana Power or NorthWestern, and I am not now. Even though I am frequently dismayed and angered by the management errors and omissions exhibited by NWE in their other operations, I cannot let those shortcomings prejudice my judgment about their performance in this case. I conclude that the public frustration and outrage over the matter are justified. However, the object of their scorn should be those policy makers who, during the course of the last decade, have lurched us into the current structure for essential utility services. And we, at least, need to acknowledge who the beneficiaries are of the current natural gas imbroglio, the unregulated suppliers who are grinning all the way to the bank.

But now by a 3 to 2 decision of the Montana Public Service Commission, NWE has been found guilty of imprudence and has been informed they will be fined a minimum of $11 million with no maximum cap set on that fine. Acting as prosecutor, judge and jury, the three members of the PSC who rendered this decision did not even inform NWE what constituted the violation until the end of the trial, which raises serious "due process" issues. They were found guilty for doing what the other natural gas default suppliers in Montana have been permitted to do for years, which raises enormous "equal protection" issues. They were found guilty for failing to accomplish the impossible, which apparently was to secure from the natural gas marketers a long term, fixed price contract at below market prices. While the Commission did not articulate the standards and rules of prudence and imprudence when they approved, on an interim basis, the application from NWE in December, NWE was found guilty "ex post facto" for doing what the PSC tacitly approved when the Commission approved the interim order in this case. Unlike standards one might expect in a civil case, NWE was found guilty for activities from which they gained no profit or benefit, and from which they never intended to gain profit or benefit. They were found guilty for doing what they are legally obligated to do, secure natural gas supplies for their default supply customers, consistent with practices judged to be prudent by the "expert witness" employed by the Montana Consumer Counsel.

The apparent motivation for this PSC decision was to protect the natural gas consumer from imprudent business decisions on the part of NWE and the author of the decision promises those consumers rate relief in the case. Unfortunately, just the opposite could be the outcome. I believe the "due process" and "equal protection" violations in this case are so egregious that its defense in court will be nearly impossible, especially since the PSC will have to defend this decision alone. It will influence a judge greatly that the Montana Consumer Counsel, established to protect Consumer interests in these kinds of cases, employed an expert witness who investigated the issues of prudence and found the gas supply acquisition strategies of NWE to be prudent. An adverse opinion from the court might also limit the flexibility of the PSC in future cases where consumer interests are at stake. Since recovery for NWE would not occur until after the court has settled the matter, the monthly consumer bills would be compounded during a compressed time period, including the accrued interest to which NWE would be entitled.

We've all watched with alarm as the financial condition of NWE has spiraled downward, creating the danger of bankruptcy. I, most assuredly, hope the company can rescue itself from that fate. If that bankruptcy occurs due to company mismanagement and poor business practices, I believe the PSC would be equipped to successfully argue that the default supply ratepayers for both electricity and natural gas should not be financially liable since they did not cause the bankruptcy. Default supply customers, especially because they are the customers of the largest profit generating center within NWE, should not be any more liable than customers of NWE's non-regulated enterprises, who have none.

On the other hand, if a precipitous and questionable decision of the PSC to protect and benefit the default customers in this case becomes the proverbial "straw that broke the camel's back," it could be argued that those customers contributed to the bankruptcy. That might create some liability on their part.

Finally, if it ultimately comes to pass that bankruptcy occurs, it will be imperative that the needs of natural gas and electricity default supply customers are served by an entity with the highest standards of financial and management integrity, proven performance and sound fiscal resources. After this ill-considered, capricious and arbitrary decision by the PSC, who on earth would that entity be?

For these reasons, I must strongly dissent from the PSC decision in Docket D2002.11.140 that NorthWestern Energy acted with imprudence as it met its responsibility to secure natural gas supplies for its default natural gas consumers.

* * * * *

The following contain my comments and observations about the specific elements and paragraphs of the proposed Final Order adopted by the Commission on a 3 to 2 vote. I will not offer specific comments about paragraphs 1 through 42 because they are largely a restatement of testimony and other evidence documented in the record in this case. I may refer to some of those paragraphs during my discussion of the remainder of the draft if they are relevant to Commission Discussion, Analysis and Findings.

Paragraph 43. No argument.

Paragraph 44. The fundamental issue is whether the Montana Public Service Commission should approve, deny, or modify the application as submitted by NorthWestern Energy.

Paragraph 45. This paragraph doesn't make any sense since there is no evidence that NWE was unaware of any of the items listed in this paragraph.

Paragraph 46. There is a certain irony in a Commission, finally considering a permanent order in a case within days of the anticipated termination of that order period, questioning the management timing of the applicant.

Paragraph 47. This paragraph implies that Mr. Donkin's testimony would indicate the imprudence of risk exposure to short-term market price indices. The testimony of Mr. Donkin on this matter is reported in paragraph 25 as follows: "In PSC-3 Mr. Donkin was asked if he considered it a prudent gas supply and acquisition strategy to have virtually all gas supply contracts under market price indices and virtually no fixed price contracts of various durations. In response Mr. Donkin said yes, but a combination of contracts having various durations, may also be prudent. He cautioned that the longer the term of fixed price contracts, the greater the risk of contract price becoming significantly out of line with prevailing market prices.[22] Mr. Donkin said he would generally not support as prudent an LDC gas supply portfolio that contains more than 20% of total supplies having fixed prices and terms of six months or greater, unless the fixed contract prices also have hedging transactions to protect against future price volatility.[23]"

Paragraph 48. No argument.

Paragraph 49. It is true that the State of Montana and the other entities listed in this paragraph did, indeed, secure a fixed price, forward contract. They secured this contract from an energy marketer whose only obligation is to deliver the supplies during the term of the contract. At the end of a contract period, the energy marketer is under no obligation to continue to deliver

[22] George Donkin response to data request PSC-3
[23] George Donkin response to data request PSC-3

supplies. The recent announcement by Energy West as an electric marketer is instructive. When an energy marketer is no longer able to secure favorable terms, they gladly and willingly shed their customers back to the default supplier. The energy marketer may choose to employ hedging strategies and may pass those hedging costs onto the marketer's customers. The energy marketer has the opportunity to profit on the commodity price. A default supplier, on the other hand, is obligated to deliver supplies to their customers before they have secured a contract for those supplies, and that obligation remains after the expiration of any supply contract. The default supplier has no assurance that hedging costs would be approved by the PSC and has no opportunity to profit from the commodity price.

Paragraph 50. It is true the *attractive* 5 year buy-back contract had insulated both NWE and its default supply customers from the extreme volatility and peak price levels during the 2000-01 crisis. This paragraph implies that the 5 year buy-back contract is a model for the kinds of fixed-price contracts that NWE should be pursuing and securing. However, we must not lose sight of the historical context in which this 5 year buy-back was put in place. The 5 year buy-back contract was not negotiated between a willing buyer/willing seller. It derived from a stipulation approved by the PSC in consideration for MPC selling its natural gas production assets. Using the proceeds of the sale, the buy-back contract established prices <u>below market</u>. It cannot be considered typical of the kinds of fixed price contracts that NWE should or could negotiate with unaffiliated suppliers. In fact, it would be illogical for a supplier to sell gas to NWE below market in either a short term or long term contract, fixed or indexed. Frankly, the admission that it insulated NWE and default customers from the market proves the contract had no relationship with the market basis of either fixed price contracts or indexed price contracts during the duration of the contract. Indeed, in the historical context, MPC/NWE only secured 8% of its natural gas supplies through fixed price contracts with unaffiliated suppliers. Total fixed price contracts (50% of supply) minus the buy-back contract (42% of supply) equals net fixed price contracts with unaffiliated suppliers (8% of supply). Faced with a Commission that, arguably, regulates and micro-manages by the guess method, ex post facto, there may be reason for NWE anxiety about Commission policy and expectations.

Paragraph 51. No argument.

Paragraph 52. It is incorrect to assert that NWE abandoned "its historic, balanced reliance on about 50% of its annual gas supply at fixed prices". The bulk of those annual gas supply contracts (42% of total) were a five year buy-back contract that expired and was not replicable as a contract between a willing buyer/willing seller. Since a key feature of the buy-back contract was that it was "below market," it is a flight of fantasy to contend, as the Commission majority in this case does, that an unregulated supplier, even one acting in good faith, would commit in a contract to sell natural gas to NWE below cost.

Paragraph 53. Where in the record evidence is there documentation that NWE experienced a "false sense of security." Again, the "fixed price buy-back contract" was unique and not readily replicable, especially since it was below market. While there may be multiple supply sources, there is no evidence any of them were or are interested in signing a fixed-price, long term contract in an "up" market, certainly not at prices below market.

Indeed, as the New York Times reported on June 16, 2003, "In the meantime, about the only beneficiaries of the natural gas shortage are companies that can profit from the high prices for the fuel by producing or transporting it in North America. These include huge energy companies like BP, which are considerable gas producers, and a coterie of smaller companies that made a prescient bet on strong demand for natural gas. Every 10-cent shift upward in gas prices, for instance, translates into a 4 percent gain in cash flow next year for Burlington Resources, which is based here (Houston). For EnCana, based in Calgary, Alberta, the same increase results in a 2.5 percent rise in cash flow, according to a study by Deutsche Bank. 'This is the strategy payoff we have been anticipating for many years,' Mr. Morgan, EnCana's chief executive, said."[24]

A FERC Staff Paper on Natural Gas Price Formation, issued June 13, 2003 and received by this office on June 18, 2003 reports the following: "Natural Gas Intelligence (NGI) recently issued an open letter to the Commission and a "Statement on Natural Gas Price Surveys" in which it noted the collapse infixed price trading and the increased use of indices during volatile periods. NGI urged 'buyers and sellers to do less indexing… and more fixed price trading, particularly in the monthly baseload market.'[25] The FERC staff then concludes, "This is another aspect of liquidity concerns—improvements in price reporting, data quality, index methodologies, reporting procedures, and the like still will not produce the desired result if there are not enough fixed price trades to form prices."[26]

While the information in the New York Times article nor the FERC Staff paper appear in the evidence in this case, they do constitute the Commission expertise and experience described in paragraph 43. Given the lack of fixed price contracts "readily" available, how might the Commission assess the prudence of any fixed price contract that might be entered into by a default supply utility.

Paragraph 54. While NWE is responsible for gas supply and procurement, they must do so within the parameters of Commission guidance and to this point, the Commission has not described the parameters of a prudent hedging strategy. Indeed, as NWE looks at the Commission record with respect to MDU and EWM, NWE could not be faulted for assuming the Commission is comfortable with price indexed gas purchases since that is the totality of the strategy pursued by those other default suppliers and which the Commission has accepted for several years. Again, both FERC and NGI information indicate the almost total lack of fixed priced trading in the current market.

Paragraph 55. Mr. Donkin's testimony about the extent to which default supply customers value relatively stable rates was not about his judgment concerning the "prudence" of a pricing strategy, but was about the use of hedging as strategy to minimize volatility. He also stated a concern about the uncertainties related to the cost of hedging. One of those uncertainties, of course, is no direction from the Commission about Commission acceptance of those costs. Indeed, the Commission has denied approval of hedging costs when requested by MDU and the clear implication is that hedging costs would not be approved for NWE.

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[24] Simon Romero, New York Times, June 16, 2003.
[25] www.intelligencepress.com/features/ngi-statement.html (Footnote 2).
[26] www.intelligencepress.com/features/ngi-statement.html

Paragraph 56. No argument.

Paragraph 57. Nothing in this recounting of Mr. Donkin's testimony indicates that he is qualifying his position that market indexed pricing is one, of several, prudent strategies.

Paragraph 58. No argument.

Paragraph 59. Mr. Donkin identifies a premium which is likely to secure a fixed-price or hedged-price. I believe the Commission has not described the parameters for acceptance of those premiums. Indeed, Commission refusal to approve hedging costs requested by MDU would confirm NWE anxiety that the Commission would not approve these premiums either.

Paragraph 60. There is no evidence that longer term bilateral and forward contract price indices or strips of 12-24 months are "readily" available to guide firm contracts. Again, the FERC and NGI reports substantiate my intuition that such contracts may not be "readily" available. While Mr. Donkin's testimony indicates the theoretical availability of such contracts, the FERC and NGI reports indicate they do not "practically" exist.

Paragraph 61. An energy supplier without default supply obligations, such as that serving the State of Montana, has different obligations and exposure than does a default supplier, and, as such, any comparison is little better than the proverbial apples and oranges comparison. The circumstances faced by MDU and EWM are more appropriate for comparison to NWE than are the circumstances faced by an independent energy supplier.

Paragraph 62. The preponderance of the recounted testimony in this paragraph is that fixed price contracts were not "readily" available. The furthest Mr. Donkin could go was the statement, "*Presumably, under certain circumstances* some sellers are willing to enter into fixed price contracts, as well." Those certain circumstances may include a premium that the Commission has not indicated the parameters for Commission acceptance. While the theoretical possibility may exist that a fixed-price contract at market may be found, there is no possibility that any producer would ever sell gas to the default supplier below market.

Paragraph 63. There is no evidence that either NWE or Mr. Donkin assign a value of zero "0" to rate stability. Indeed, the very nature of NWE operations from which they earn a rate of return, their distribution functions, is volumetric based and high prices and volatile prices create price induced conservation which reduces the volumes of delivered gas upon which NWE can earn a rate of return. Because they face a circumstance where fixed price contracts are not "readily" available, does not mean they discount the price stabilization values of those contracts.

Paragraph 64. Bullet one refutes the assertion in paragraph 63 that NWE assigns zero "0" to long term rate stability. Bullet two again ignores the fundamentally unique characteristics of the bulk of the historical fixed price contracts utilized by MPC/NEW, i.e. the buy-back contract was <u>below market</u>. Only 8% of supplies have been secured with fixed price contracts with unaffiliated suppliers.

Paragraph 65. This whole paragraph egregiously ignores the fundamentally unique and non-replicable nature of the 5 year buy-back contract. It has already been established that the buy-back contract was for “below market” prices because it insulated NWE and the consumers from the real market at the time. To suggest that NWE was imprudent because it didn’t “replace the fixed price buy-back contract with a *comparable* fixed price contract is absurd on its face. No new, fixed price contracts are going to be available at deliberately “below market” prices as the five year buy-back was.

Paragraph 66. While NWE has the need to act, the PSC is obligated to articulate the standards against which those actions will be judged beforehand, not ex post facto has it has done in this case.

Paragraph 67. Again, there is only the “theoretical” possibility that such contracts were available.

Paragraph 68. It is absolutely inappropriate to suggest within this order for this docket the determinations certain to be made in a different, though related, docket that has not yet been formally heard by the Commission, but has received only a non-hearing overview and cursory Commission work-session attention.

Paragraph 69. Not only is the Commission majority in this case second guessing market prices in the look-back period, they are no proposing to fix prices for the future period.

Paragraph 70. No argument with this language, although additional language should be added that NWE derives no profit from natural gas prices and the increases result in no additional profit to NWE. Those who do profit from these price increases are assumed to be beyond the regulatory authority of the Montana Public Service Commission and they are dining well in Calgary, Denver and Houston. Compared to the typical willing buyer/willing seller transaction, this pairs NWE as an <u>obligated</u> buyer versus the willing sellers who are also free to be willing non-sellers. The impact of this relationship should also be examined by the Working Committee.

Paragraph 71. No argument.